



**DELAWARE STATE LOTTERY**

Financial Statements

June 30, 2007 and 2006

(With Independent Auditors' Report Thereon)

# DELAWARE STATE LOTTERY

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## Independent Auditors' Report

Wayne Lemons, Director of the Delaware State Lottery and  
Richard S. Cordrey, Secretary of Finance, State of Delaware:

We have audited the accompanying balance sheets of the Delaware State Lottery (the Lottery) as of June 30, 2007 and 2006, and the related statements of revenue, expenses, and change in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Lottery's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in note 1 to the financial statements, the financial statements present only the Lottery and do not purport to, and do not, present fairly the financial position of the State of Delaware as of June 30, 2007 and 2006, and the changes in its financial position for the years then ended in conformity with U.S. generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Delaware State Lottery as of June 30, 2007 and 2006, and its changes in financial position and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 9, 2007, on our consideration of the Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.



Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplemental information. However, we did not audit the information and express no opinion on it.

KPMG LLP

October 9, 2007



KPMG LLP  
1601 Market Street  
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**Report on Internal Control Over Financial Reporting and on Compliance and Other  
Matters Based on an Audit of Financial Statements Performed in Accordance With  
*Government Auditing Standards***

Wayne Lemons, Director of the Delaware State Lottery and  
Richard S. Cordrey, Secretary of Finance, State of Delaware:

We have audited the financial statements of the Lottery as of and for the year ended June 30, 2007, and have issued our report thereon dated October 9, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

***Internal Control Over Financial Reporting***

In planning and performing our audit, we considered the Lottery's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Lottery's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Lottery's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

***Compliance and Other Matters***

As part of obtaining reasonable assurance about whether the Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the



determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of the Lottery in a separate letter dated October 9, 2007.

This report is intended solely for the information and use of the Secretary of Finance, Lottery Management, the Office of the Governor, the Office of the Controller General, the Office of the Attorney General, the Office of Management and Budget, and the Office of the Auditor of Accounts and others within the entity and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

October 9, 2007

## **DELAWARE STATE LOTTERY**

### **Management's Discussion and Analysis**

**June 30, 2007 and 2006**

The management of the Delaware State Lottery (the Lottery) offers this narrative overview and analysis of the Lottery's financial activities for the years ended June 30, 2007 and 2006, which should be read in conjunction with the Lottery's basic financial statements.

#### ***Overview of the Basic Financial Statements***

This discussion and analysis is intended to serve as an introduction to the Lottery's basic financial statements. Since the Lottery is an enterprise fund of the State of Delaware, these financial statements are presented in a manner similar to a private-sector business. As required by accounting principles generally accepted in the United States (GAAP), current year's revenues are recorded when earned and expenses are recorded as they are incurred, regardless of when the cash is received or disbursed.

The balance sheet presents information on all of the Lottery's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets serve as a relative indicator of the change in financial position of the Lottery.

The statement of revenue, expenses, and change in net assets shows the result of the Lottery's total operations during the fiscal year and reflects both operating and nonoperating activities. Changes in net assets (increases or decreases) reflect the current fiscal period's operating impact upon the overall financial position of the Lottery.

The statement of cash flows provides a detailed analysis of all sources and uses of cash. The direct method of cash flows is presented, ending with a reconciliation of operating income to net cash provided by operating activities. The statement of cash flows is divided into three activities sections—operating, noncapital financing, and investing.

Notes to the basic financial statements contain additional information, and often offer explanations to the basic financial statements. The notes are intended to assist the reader in understanding the Lottery's basic financial statements.

**DELAWARE STATE LOTTERY**  
Management's Discussion and Analysis  
June 30, 2007 and 2006

**Condensed Balance Sheets**

**Table 1**  
**Balance Sheets**  
(In millions)

<b>Assets</b>	<b>2007</b>	<b>June 30 2006</b>	<b>2005</b>
Cash and cash equivalents	\$ 8.6	6.1	5.8
Accounts receivable, net of allowance of \$0.7, \$0.7, and \$0.7, respectively	12.5	8.7	6.4
Investments	6.6	8.5	9.9
Prepaid expenses	—	—	0.5
Capital assets, net	—	0.1	0.2
Deposit with Multi-State Lottery	1.7	1.9	1.7
<b>Total assets</b>	<b>\$ 29.4</b>	<b>25.3</b>	<b>24.5</b>
<b>Liabilities and Net Assets</b>			
<b>Liabilities:</b>			
Prizes liability, including \$6.6, \$8.5, and \$9.9, respectively, of prize installment obligation	\$ 10.7	12.5	13.0
Accounts payable and accrued liabilities	8.5	5.8	4.5
Multi-State Lottery Reserve	1.7	1.9	1.7
Due to the State of Delaware	7.5	4.1	4.4
<b>Total liabilities</b>	<b>28.4</b>	<b>24.3</b>	<b>23.6</b>
<b>Net assets:</b>			
Invested in capital assets	—	0.1	0.2
Unrestricted	1.0	0.9	0.7
<b>Total net assets</b>	<b>1.0</b>	<b>1.0</b>	<b>0.9</b>
<b>Total liabilities and net assets</b>	<b>\$ 29.4</b>	<b>25.3</b>	<b>24.5</b>

The Lottery's accounting periods are predicated on a 4-4-5 week cycle except at year-end when the closing date includes additional days up to and including June 30th. These extra days amounted to four in 2005, five in 2006, and six in 2007. Correspondingly, the additional days in 2005, 2006, and 2007 are reflected in the additional accounts receivable.

Investments and the related prize installment obligations have been reduced over the years as a result of the existing annuities maturing and the Lottery no longer utilizing annuities for prize payments.



**DELAWARE STATE LOTTERY**  
Management's Discussion and Analysis  
June 30, 2007 and 2006

**Revenue**

**Table 2**  
**Revenue**  
(In millions)

	Year ended June 30		
	2007	2006	2005
Play 3	\$ 26.9	27.6	27.6
Play 4	17.6	17.2	16.8
Multi Win Lotto	7.1	7.5	4.0
Lotto	—	—	11.5
Raffle	1.0	—	—
Powerball	29.5	38.0	24.2
Powerplay	3.1	2.8	1.3
Instant games	33.1	31.4	28.7
Traditional games revenue	118.3	124.5	114.1
Video lottery, net	635.7	603.5	575.2
Video lottery machine license fees	1.1	—	—
Total revenue	\$ 755.1	728.0	689.3

Table 2 above compares revenue for each lottery game category. Total lottery revenue from ongoing operations for fiscal year 2007 was \$27 million or 3.7% higher than for fiscal 2006 which was 5.6% higher than for fiscal 2005. A law was passed for fiscal 2007 that enabled the Lottery to charge a video lottery machine license fee to each licensed venue that exceeds a total of 2,500 machines at their facility. This revenue, labeled as "Video lottery machine license fees" above, was not used in calculating the percentage of the revenue increase.

The All Cash Lotto game was discontinued at the beginning of fiscal 2006. Multi-Win Lotto, which was introduced during fiscal 2005, was operational for all of 2006, thus resulting in increased sales.

Fiscal 2006 Powerball and Powerplay sales that are typically driven by the size of the jackpot were 57% and 115% higher than fiscal 2005, respectively, as a result of substantially higher jackpot levels attained during 2006. In contrast, 2007 sales decreased \$8.2 million or 20.1% from 2006, since 2006 had two jackpots over \$300 million and fiscal 2007 didn't have any.

Instant games continue to show a steady increase. The "cooperative services" agreement that the Lottery signed with its vendor for instant games continued to produce positive results. The vendor, in conjunction with the Lottery, continued to offer more attractive products. The Lottery also decided to shorten the life cycle of games offered and increased the introduction of higher price point tickets, as surveys indicated that higher price points with higher prize levels were more attractive to the playing public.

Video lottery also continued its steady increase due to the addition of machines and the extension of operating hours.

**DELAWARE STATE LOTTERY**  
Management's Discussion and Analysis  
June 30, 2007 and 2006

**Cost of Games**

**Table 3**  
**Cost of Games**  
(As a % of sales)

	Year ended June 30		
	2007 % of sales	2006 % of sales	2005 % of sales
Commission expense	41.0%	40.6%	40.9%
Gaming vendor fees and costs	5.8	5.6	5.7
Franchise game fees	0.4	0.3	0.1
Prize expense	8.1	8.9	8.7

Commission expense includes payments to lottery retailers for selling lottery tickets and to video lottery agents for operation of video lottery facilities. Commission expense as a percent of sales remained relatively unchanged for all three years.

Gaming vendor fees and costs include costs of the central system used to monitor and collect pertinent data for the online and the video lottery system and costs of leasing video lottery terminals from gaming vendors. Gaming vendor fees and costs remained relatively unchanged as a percent of sales for all three years.

**Prize Expense, Net of Reversions**

**Table 4**  
**Prize Expense, Net of Reversions**  
(In millions)

	Year ended June 30		
	2007	2006	2005
Play 3	\$ 12.4	12.6	12.5
Play 4	8.3	8.3	8.0
Multi Win Lotto	3.9	4.2	2.5
Lotto	—	—	7.0
Raffle	0.5	—	—
Powerball	13.7	18.4	11.3
Powerplay	1.5	1.4	0.6
Instant games	21.0	20.0	17.9
Total prize expense	\$ 61.3	64.9	59.8

## DELAWARE STATE LOTTERY

### Management's Discussion and Analysis

June 30, 2007 and 2006

Table 4 above compares prize expense for each lottery game category for the past three years. In general, prize expense by game will increase or decrease from year to year in proportion to the increase or decrease in sales for a particular game. However, the prize expenses for the Play 3 and Play 4 games are impacted by the luck of the draw and actual prize payment is determined by lottery players' luck in matching the particular set of numbers randomly selected in each drawing for each game. Prize expense for the instant game product category is controllable for the most part, by printing a predetermined number and value of winning tickets for each instant game.

Prize expense for 2007 compared to 2006 and 2006 compared to 2005 is commensurate with the increases and decreases in sales during the same periods.

### Operating Expenses

**Table 5**  
**Operating Expenses**  
(In millions)

	Year ended June 30		
	2007	2006	2005
Operating expenses	\$ 6.5	5.7	6.5

The main reason for the \$0.8 million increase in 2007 when compared to 2006 and the \$0.8 million decrease in 2006 when compared to 2005 was that during 2006, the Lottery discontinued reserves that it had maintained for the All Cash Lotto. This resulted in almost a half million dollar decrease in general and administrative expenses.

### Nonoperating Expenses

**Table 6**  
**Nonoperating Expenses**  
(In millions)

	Year ended June 30		
	2007	2006	2005
Contributions to the State of Delaware:			
Standardbred Breeder's program	\$ 3.0	3.0	3.0
Certified Thoroughbred program	1.0	—	—
Contributions to the State of Delaware	327.0	316.0	297.9
Total nonoperating expenses	\$ 331.0	319.0	300.9

Increases in cash contributions to the State of Delaware were consistent with lottery revenue increases.

# DELAWARE STATE LOTTERY

## Balance Sheets

June 30, 2007 and 2006

<b>Assets</b>	<b>2007</b>	<b>2006</b>
Current assets:		
Cash and cash equivalents	\$ 8,652,993	6,122,398
Accounts receivable, net of allowance of \$724,864 and \$726,248, respectively	12,492,244	8,723,164
Investments – restricted for payment of prize liabilities	2,052,815	2,232,690
Prepaid expenses	—	40,280
Total current assets	23,198,052	17,118,532
Noncurrent assets:		
Capital assets, net	6,781	68,830
Investments – restricted for payment of prize liabilities	4,545,589	6,223,034
Deposit with Multi-State Lottery	1,683,048	1,898,623
Total noncurrent assets	6,235,418	8,190,487
Total assets	\$ 29,433,470	25,309,019
<b>Liabilities and Net Assets</b>		
Current liabilities:		
Prizes liability, including \$2,052,815 and \$2,232,690, respectively, of prize installment obligations	\$ 6,150,681	6,309,755
Accounts payable and accrued liabilities	8,491,160	5,811,428
Due to the State of Delaware	7,562,992	4,122,629
Total current liabilities	22,204,833	16,243,812
Noncurrent liabilities:		
Multi-State Lottery reserve	1,683,048	1,898,623
Prize installment obligations, noncurrent	4,545,589	6,223,034
Total liabilities	28,433,470	24,365,469
Net assets:		
Invested in capital assets	6,781	68,830
Unrestricted	993,219	874,720
Total net assets	1,000,000	943,550
Total liabilities and net assets	\$ 29,433,470	25,309,019

See accompanying notes to financial statements.

# **DELAWARE STATE LOTTERY**

## Statements of Revenue, Expenses, and Change in Net Assets

Years ended June 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Revenue:		
Video lottery, net	\$ 635,676,294	603,501,083
Video lottery machine license fees	1,186,999	—
Online games	85,196,546	93,137,268
Instant games	33,067,084	31,354,597
Total revenue	<u>755,126,923</u>	<u>727,992,948</u>
Cost of games:		
Video lottery commissions	302,239,827	287,527,716
Video lottery franchise game fees	3,100,349	2,038,286
Prize costs, net of reversions	61,324,989	64,878,620
Gaming vendor fees and costs	43,864,367	40,835,730
Online and instant games commissions	7,018,780	8,042,530
Sales aids	18,384	24,243
Total cost of games	<u>417,566,696</u>	<u>403,347,125</u>
Gross profit	<u>337,560,227</u>	<u>324,645,823</u>
Operating expenses:		
Advertising and promotions	2,484,138	2,408,790
Payroll and related benefits	1,832,546	1,647,545
Other general and administrative	2,165,275	1,463,780
Depreciation expense	62,049	130,362
Total operating expenses	<u>6,544,008</u>	<u>5,650,477</u>
Operating income	331,016,219	318,995,346
Nonoperating expenses:		
Contributions to the Delaware Standardbred Breeder's Program	3,000,000	3,000,000
Contributions to the Delaware Certified Thoroughbred Program	1,000,000	—
Contributions to the State of Delaware	326,959,769	315,985,699
Change in net assets	56,450	9,647
Net assets at beginning of year	943,550	933,903
Net assets at end of year	<u>\$ 1,000,000</u>	<u>943,550</u>

See accompanying notes to financial statements.

# DELAWARE STATE LOTTERY

## Statements of Cash Flows

Years ended June 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Cash flows from operating activities:		
Receipts from customers	\$ 750,170,844	725,713,366
Payments to vendors for goods and services	(49,823,459)	(46,081,091)
Payments to employees for services	(1,792,421)	(1,648,089)
Payments for prizes	(63,161,508)	(65,280,855)
Payments for commissions	(307,200,775)	(294,532,109)
Net cash provided by operating activities	<u>328,192,681</u>	<u>318,171,222</u>
Cash flows from noncapital financing activities:		
Contributions to the Delaware Standardbred Breeder's Program	(3,000,000)	(3,000,000)
Contributions to the Delaware Certified Thoroughbred Program	(1,000,000)	—
Contributions to the State of Delaware	(323,519,406)	(316,248,183)
Net cash used in noncapital financing activities	<u>(327,519,406)</u>	<u>(319,248,183)</u>
Cash flows from investing activities:		
Proceeds from maturity of investments	1,857,320	1,395,524
Net cash provided by investing activities	<u>1,857,320</u>	<u>1,395,524</u>
Net increase in cash and cash equivalents	2,530,595	318,563
Cash and cash equivalents at beginning of year	6,122,398	5,803,835
Cash and cash equivalents at end of year	<u>\$ 8,652,993</u>	<u>6,122,398</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 331,016,219	318,995,346
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense	62,049	130,362
Changes in operating assets and liabilities:		
Accounts receivable, net	(3,769,080)	(2,279,582)
Prepaid expenses	215,575	448,234
Deposit with Multi-State Lottery	40,280	(197,876)
Prizes liability	(1,836,519)	(402,235)
Accounts payable and accrued liabilities	2,464,157	1,476,973
Net cash provided by operating activities	<u>\$ 328,192,681</u>	<u>318,171,222</u>

See accompanying notes to financial statements.

## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2007 and 2006

#### (1) Summary of Significant Accounting Policies

##### (a) *Legislative Enactment*

The Delaware State Lottery (the Lottery) was established by Enabling Legislation (the Legislation) passed on May 31, 1974, by the General Assembly of the State of Delaware (the General Assembly) under the authority of the Governor's Office and under the supervision of a Director. In July 1976, the Lottery was transferred to the Office of the Secretary of Finance. The Director has the power and duty to establish rules for conducting games, including the type and number of games, the price of tickets, the number and amounts of winning tickets, the manner of selecting winning tickets, the manner of prize payment, frequency of drawings, locations and methods for the sale of tickets, procedures for licensing of retailers, and all other functions related to the operation of the Lottery.

The Legislation provides that for the nonvideo lottery games at least 45% of total revenue shall be used to pay prizes, operating expenses shall not exceed 20% of total revenue and at least 30% of total revenue will be paid to the General Fund of the State of Delaware (the State). Enabling legislation for video lottery was enacted on July 16, 1994 and provides that for the video lottery games at least 87%, but not more than 95% (unless approved by the Director), of total proceeds on an average annual basis shall be used to pay prizes.

##### (b) *Reporting Entity*

The Delaware State Lottery (reporting entity) is an enterprise fund of the State of Delaware.

##### (c) *Basis of Presentation*

In accordance with accounting principles generally accepted in the United States, the financial statements are prepared on the accrual basis of accounting, which requires recognition of revenues when earned and expenses when incurred. The Lottery has elected not to apply all Financial Accounting Standards Board statements and interpretations issued after November 30, 1989, in accordance with Government Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*.

##### (d) *Cash and Cash Equivalents*

Cash and cash equivalents consist of deposits held in bank accounts and highly liquid overnight investment accounts, as well as deposits held by the State to fund future nonprize costs during the next month.

## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2007 and 2006

(e) **Accounts Receivable**

Accounts receivable consist primarily of unsettled balances due to the Lottery from the racetracks for video lottery, and from retailers, which principally include grocery and convenience stores serving as the primary distribution channel for traditional lottery sales (online and instant games) to the general public.

	<u>2007</u>	<u>2006</u>
Receivables:		
Accounts	\$ 13,217,108	9,449,412
Total receivables	13,217,108	9,449,412
Allowance for doubtful accounts	(724,864)	(726,248)
Total receivables, net	\$ <u>12,492,244</u>	<u>8,723,164</u>
Amounts not scheduled for collection during the subsequent year	\$ —	—

(f) **Investments**

Investments consist of annuity contracts purchased from insurance companies to fund future prize payments, and are carried at amortized cost as nonparticipating investment contracts. The practice of purchasing and holding annuity contracts to fund future prize obligations is no longer employed by the Lottery, as investment amounts reported represent annuity contracts whose most recent purchase was during 1998. It is the Lottery's policy to hold all investments of this nature that were purchased to fund prize obligations until maturity. All investments will have matured as of February 16, 2018, at which time such investments will no longer be reported by the Lottery.

(g) **Capital Assets**

All purchases of capital assets, mostly computer equipment and furniture and fixtures, in excess of \$15,000 are capitalized and carried at cost. Depreciation is computed by using the straight-line method over the estimated useful life of ten years. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal.

(h) **Revenue Recognition**

Revenue from online games is recognized on the day of the drawing. Revenue from the sale of instant tickets is recognized when the book has been activated and when one of the following occurs:

- 85% of the related prizes of an activated book is paid;
- 90 days from the date of activation; or
- when the next pack of the same game is activated.

Revenue from video lottery sales is recognized, net of prizes paid, at the time the public plays the game.



## **DELAWARE STATE LOTTERY**

### **Notes to Financial Statements**

June 30, 2007 and 2006

All revenue that the Lottery reports is considered operating revenue.

**(i) *Prize Obligations***

Prize obligations for the online games are determined and recognized after each drawing is held. For the numbers games, winners are paid a certain amount depending upon the number of, or order of, winning numbers. Of every Multi Win Lotto sales dollar, a fixed payment goes to fund the 9 lower prize levels with the balance going into the jackpot. If there are no jackpot winners in the Lotto game, the amount is carried forward until there is a winner. For the Powerball, 50% of the revenues are allocated to the prize pool.

Prize obligations related to instant games are recognized by taking the greater of prize cash disbursements or the historical estimates of claimed prizes. Disbursements for prizes, including installment prize awards, are charged against the obligations for unpaid prize awards. Prizes unclaimed after one year revert back to the Lottery and reduce the prize costs for the year. Such unclaimed monies are then remitted to the State.

**(j) *Compensated Absences***

The Lottery has accrued a liability included in accounts payable and accrued liabilities for future absences, recognizing the obligation relating to services already rendered. This liability represents benefits accrued to Lottery employees for vacation earned as of year-end and sick leave estimated to be paid out at retirement for services rendered as of June 30, 2007. Employees earn from 1.25 to 1.75 days of vacation leave per month depending on years of service. The employee or his estate is paid for unused vacation upon termination of employment. Employees earn 1.25 days of sick leave per month. The Lottery's obligation for sick leave credit is a maximum of 45 work days. As of June 30, 2007 and 2006, the Lottery had liabilities of \$106,319 and \$96,913 for accrued vacation and \$139,179 and \$125,086 for accrued sick leave, respectively.

**(k) *Operating and Nonoperating Expenses***

Operating expenses generally result from providing services and producing and delivering goods in connection with the Lottery's principal ongoing operations. Operating expenses of the Lottery include personnel costs, contracted services, supplies, and depreciation. All expenses not meeting this definition are reported as nonoperating expenses.

**(2) *Cash***

Cash and cash equivalents reported reflect three types of account balances: The Lottery deposit account, the Lottery prize account, and deposits held by the State. Cash receipts and all cash transfers to other State agencies are made in and out of the Lottery deposit account. Prize disbursements are made out of the Lottery prize account. Cash held by the State (Treasurer's Office), while identified for the Lottery, is maintained in an internal investment pool controlled by the State.

## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2007 and 2006

Cash balances consisted of the following:

	June 30	
	2007	2006
On hand and in bank	\$ 6,298,462	4,292,078
Held by the State	2,354,531	1,830,320
	<u>\$ 8,652,993</u>	<u>6,122,398</u>

#### (a) *Custodial Credit Risk*

All deposits are required by State law to be collateralized by direct obligations of, or obligations guaranteed by, the U.S. government or other suitable obligations as determined by the State's Cash Management Policy Board (the Board), unless the Board shall find such collateralization not in the best interest of the State. Additionally, the Board has determined that deposits need not be collateralized provided they are held in a bank that for the previous two years has had a return on total average assets of 0.5% or greater and has had an average capital ratio (total equity to total assets) of at least 5%. If the bank does not meet the aforementioned criteria, collateral must consist of one or more of the following:

- U.S. government securities;
- U.S. government agency securities;
- Federal Home Loan Board letters of credit;
- State securities; or
- Securities of a political subdivision of the State with a Moody's Investors service rating of "A" or better.

In addition, the bank must ensure that those securities pledged as collateral have a market value equal to or greater than 102% of the ledger balance(s) in the account(s) each day and ensure that securities pledged are identified as held in the State's name and are segregated on the bank's records.

At June 30, 2007 and 2006, the bank in which amounts representing deposits and cash on hand are maintained met the aforementioned State-mandated standards, thus alleviating the need for collateralization. Also, at June 30, 2007 and 2006, the financial institutions maintaining the State's internal investment pool satisfied the aforementioned criteria; thus, the investments managed by those institutions do not require collateralization.

As of June 30, 2007 and 2006, the total bank balance of cash in all bank accounts was \$6,323,030 and \$4,351,069, respectively.

#### (3) **Investments**

Until April 1998, annuity contracts were purchased from insurance companies to fund prizes of \$150,000 or more; payable on an installment basis. All investments reported on the balance sheet represent such annuities, and are carried on the balance sheet at amortized cost. The fair value of some of these

# DELAWARE STATE LOTTERY

## Notes to Financial Statements

June 30, 2007 and 2006

investments is not easily determinable; however, it is the Lottery's intent to hold the investments until maturity. The Lottery remains liable for future periodic payments of deferred prize obligations (approximately \$6.6 million as of June 30, 2007) in the event that annuity issuers default on their obligations. Lottery investments as of June 30, 2007 and 2006 are considered uncategorized investments as it relates to custodial credit risk under GASB Statement No. 40, *Deposit and Investment Risk Disclosures*.

### (a) *Interest Rate Risk*

Interest rate risk is the risk that changes in interest rates of debt instruments will adversely affect the value of an investment. Investments reported on the balance sheet are not subject to interest rate risk.

### (b) *Credit Risk and Concentration of Credit Risk*

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. While the Lottery no longer utilizes the purchase of annuity contracts to fulfill prize obligations, the Lottery places no limit on the amount it may invest in any one issuer. As of June 30, 2007, the insurance companies with which the Lottery's investments in annuity contracts to pay future prize obligations are held were rated by A.M. Best Company and concentrated as follows:

<u>Insurance company</u>	<u>Total annuity contract values</u>	<u>Concentration</u>	<u>A.M. Best rating</u>
Sun America Life Insurance Company	\$ 97,058	1.47%	aa+ (superior)
Jefferson-Pilot Life Insurance Company	3,251,215	49.27	aa (superior)
John Hancock Life Insurance Company	22,662	0.34	aa+ (superior)
Metropolitan Life Insurance Company	1,770,224	26.83	aa (superior)
Mutual of America Life Insurance Co.	647,164	9.81	A+ (excellent)
New York Life Insurance Company	304,141	4.61	aaa (superior)
Ohio National Life Insurance Company	505,940	7.67	aa- (superior)
Total investments in annuity contracts	\$ <u>6,598,404</u>	<u>100.00%</u>	

# DELAWARE STATE LOTTERY

## Notes to Financial Statements

June 30, 2007 and 2006

### (4) Capital Assets

	<b>Beginning balance July 1, 2006</b>	<b>Increase</b>	<b>Decrease</b>	<b>Ending balance June 30, 2007</b>
Capital assets being depreciated:				
Computer equipment and software	\$ 1,394,887	—	—	1,394,887
Total capital assets being depreciated	1,394,887	—	—	1,394,887
Less accumulated depreciation	1,326,057	62,049	—	1,388,106
Total capital assets being depreciated, net	\$ 68,830			6,781
	<b>Beginning balance July 1, 2005</b>	<b>Increase</b>	<b>Decrease</b>	<b>Ending balance June 30, 2006</b>
Capital assets being depreciated:				
Computer equipment and software	\$ 1,394,887	—	—	1,394,887
Total capital assets being depreciated	1,394,887	—	—	1,394,887
Less accumulated depreciation	1,195,695	130,362	—	1,326,057
Total capital assets being depreciated, net	\$ 199,192			68,830

During the years ended June 30, 2007 and 2006, the Lottery had no purchases or disposals of capital assets. Depreciation expense for the years ended June 30, 2007 and 2006 was \$62,049 and \$130,362, respectively.

### (5) Prize Obligations

The following is a reconciliation of changes in the prize liability account, which includes the present value of prize installment obligations, for the fiscal years ended June 30, 2007 and 2006:

	<b>2007</b>	<b>2006</b>
Prize obligations, beginning of year	\$ 12,532,789	12,935,024
Prize payments	(63,161,508)	(65,280,855)
Prize costs, net of reversions	61,324,989	64,878,620
Prize obligations, end of year	\$ 10,696,270	12,532,789

## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2007 and 2006

The Lottery pays the winners of certain jackpots in annual installments over periods that vary generally from 14 to 20 years. The future prize installment obligations payable as of June 30, 2007, and during the next five years and thereafter, are as follows:

2008	\$	2,151,350
2009		1,837,200
2010		1,384,575
2011		949,800
2012		666,625
Thereafter		<u>491,500</u>
Total payments for unpaid prize installment obligations		7,481,050
Less imputed interest		<u>(882,646)</u>
Present value of prize installment obligations	\$	<u><u>6,598,404</u></u>

#### (6) Participation in the Multi-State Lottery

The Lottery is a member of the Multi-State Lottery (the MUSL), which operates online games on behalf of participating state lotteries. Each MUSL member sells game tickets through its agents and makes weekly wire transfers to the MUSL in an amount equivalent to the member's share of the estimated grand prize liability. Each MUSL member pays lesser prizes directly to the winners. The MUSL operates the Powerball games, as well as the Powerplay feature associated with Powerball. Participating lotteries are required to maintain deposits with MUSL for contingency reserves to protect MUSL from unforeseen prize liabilities. The money in this reserve fund is refundable to MUSL members if the MUSL disbands or if a member leaves the MUSL Board.

The amount the Lottery had on deposit with the MUSL, as of June 30, 2007 and 2006, equaled \$1,683,048 and \$1,898,623, respectively. These amounts are also reported as a liability on Lottery's balance sheet because they represent the amount to be paid to the State upon separation from the MUSL if the MUSL is not required to use a portion of the Lottery's reserves held by the MUSL.

Complete separate financial statements for the MUSL may be obtained by sending a written request to the Lottery's Administrative Office.

#### (7) Delaware Standardbred Breeder's Program

In March 1998, an amendment to the Legislation was passed by the General Assembly that established the Delaware Standardbred Breeder's Program (the Breeder's Program) for the purpose of promoting the Delaware harness racing industry. Under this amendment, the Lottery was initially required to withhold \$2,000,000 of funds annually (\$1,000,000 from the General Fund of the State and \$1,000,000 from the Purse Increase Funds of the State Department of Agriculture) and remit these fees to the Breeder's Program. Under an amendment signed in April 2004, the Lottery is required to withhold \$3,000,000 of funds annually (\$1,500,000 from the General Fund of the State and \$1,500,000 from the Purse Increase Funds of the State Department of Agriculture) and remit these fees to the Breeder's Program.

## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2007 and 2006

In the epilogue language of the Fiscal Year 2006 Bond Bill, an amendment was passed by the General Assembly that established the Delaware Certified Thoroughbred Program for the purpose of enhancing the quantity of thoroughbred foals and/or yearlings stabled within Delaware. Under this amendment, effective July 1, 2006, the Lottery is required to withhold \$1,000,000 of funds annually (\$500,000 from the General Fund of the State and \$500,000 from the Purse Increase Funds of the State Department of Agriculture) and remit these funds to the Delaware Certified Thoroughbred Program.

#### (8) Contributions to the State of Delaware

As required, under the Legislation, net assets of the Lottery may not exceed \$1,000,000; therefore, the Lottery periodically transfers surplus funds to the State in accordance with the Legislation. For the years ended June 30, 2007 and 2006, the Lottery made the following contributions to the State and, as of June 30, 2007 and 2006, had the following liabilities due to the State for excess earnings:

	<b>June 30</b>	
	<b>2007</b>	<b>2006</b>
Amounts transferred during the fiscal year:		
General Fund	\$ 256,700,000	248,800,000
Department of Health and Social Services	1,919,230	1,548,214
Department of Agriculture	64,900,176	65,899,969
	<u>323,519,406</u>	<u>316,248,183</u>
Amounts accrued, beginning of year	(4,122,629)	(4,385,113)
Amounts due to the State, end of year:		
General Fund	—	—
Department of Health and Social Services	162,724	289,098
Department of Agriculture	7,400,268	3,833,531
	<u>7,562,992</u>	<u>4,122,629</u>
Amounts accrued, end of year		
Total contributions to the State of Delaware	<u>\$ 326,959,769</u>	<u>315,985,699</u>

# DELAWARE STATE LOTTERY

## Notes to Financial Statements

June 30, 2007 and 2006

### (9) Revenue and Expenses by Game

The following revenue was recognized:

	<b>Year ended June 30</b>	
	<b>2007</b>	<b>2006</b>
Online games:		
Play 3 Day	\$ 9,768,918	10,017,850
Play 3 Night	17,102,103	17,548,614
Play 4 Day	6,150,303	5,994,346
Play 4 Night	11,474,098	11,219,002
Multi Win Lotto	7,081,815	7,511,185
Raffle	999,780	—
Powerball	29,510,089	38,071,911
Powerplay	3,109,440	2,774,360
	<u>85,196,546</u>	<u>93,137,268</u>
Video lottery, net	635,676,294	603,501,083
Video lottery machine license fees	1,186,999	—
Instant	<u>33,067,084</u>	<u>31,354,597</u>
	<u>\$ 755,126,923</u>	<u>727,992,948</u>

The revenue, prize costs, and commissions expense, by game type, are listed below:

	<b>Online</b>	<b>Video lottery, net</b>	<b>Instant</b>	<b>Total</b>
Year ended June 30, 2007:				
Revenue	\$ 85,196,546	635,676,294	33,067,084	753,939,924
Other income	—	1,186,999	—	1,186,999
Prize costs, net of reversions	<u>40,360,969</u>	<u>—</u>	<u>20,964,020</u>	<u>61,324,989</u>
	<u>44,835,577</u>	<u>636,863,293</u>	<u>12,103,064</u>	<u>693,801,934</u>
Commissions expense	<u>5,120,691</u>	<u>302,239,827</u>	<u>1,898,089</u>	<u>309,258,607</u>
Contribution margin per game	<u>\$ 39,714,886</u>	<u>334,623,466</u>	<u>10,204,975</u>	<u>384,543,327</u>
Year ended June 30, 2006:				
Revenue	\$ 93,137,268	603,501,083	31,354,597	727,992,948
Prize costs, net of reversions	<u>44,916,073</u>	<u>—</u>	<u>19,962,547</u>	<u>64,878,620</u>
	<u>48,221,195</u>	<u>603,501,083</u>	<u>11,392,050</u>	<u>663,114,328</u>
Commissions expense	<u>6,245,049</u>	<u>287,527,716</u>	<u>1,797,481</u>	<u>295,570,246</u>
Contribution margin per game	<u>\$ 41,976,146</u>	<u>315,973,367</u>	<u>9,594,569</u>	<u>367,544,082</u>

## **DELAWARE STATE LOTTERY**

### **Notes to Financial Statements**

June 30, 2007 and 2006

#### **(10) Payroll-Related and Other Benefits**

All Lottery personnel are employees of the State and are covered by pension, health insurance, and other employee benefit programs administered by agencies of the State. During 2007 and 2006, the Lottery incurred \$1,832,546 and \$1,647,545, respectively, of payroll-related costs, including pension, health insurance, and other employee benefit costs, paid to various State agencies responsible for the administration of benefit programs.

#### **(11) Retirement and Other Postemployment Benefits**

The Lottery contributes to the State Employees' Pension Plan (the State Plan) established by the State to provide benefits for State employees. While the State Plan is an agent multiple employer public employee retirement system, the Lottery accounts for the plan as a cost-sharing multiple employer public employees retirement system since a separate valuation is not performed for the Lottery and the Lottery's only obligation to the plan is its required annual contributions. The State Plan is considered part of the State's financial reporting entity, and is not considered as part of the Lottery's reporting entity. The State Plan prepares separate financial statements, which can be obtained by writing to the State Board of Pension Trustees and Office of Pensions, McArdle Building, Suite #1, 860 Silver Lake Boulevard, Dover, Delaware 19904-2402.

The State Plan consists of several plans, which are managed by the State. The various plans have different vesting periods ranging from 5 to 20 years, various eligibility requirements, and various benefits that are provided. The Lottery's required contributions, which equaled actual contributions made for the years ended June 30, 2007, 2006, and 2005, were \$187,006, \$162,331, and \$139,226, respectively.

The Lottery's accrued pension costs for the years ended June 30, 2007 and 2006 equaled \$11,205 and \$9,675, respectively, and are included within amounts reported as accounts payable and accrued liabilities on the balance sheets.

#### **(12) Risk Management**

The Lottery stipulates in its vendor contracts that the vendors carry various insurance coverages such as property (video gaming machines and online terminals, etc.), general liability, errors and omissions, automotive and crimes. The Lottery's risks of losses related to workers' compensation, employee health care, automobile and a portion of property and casualty claims are insured internally by the State.

#### **(13) Commitments**

The Lottery has entered into various contracts for services to be rendered relating principally to the operation of the Lottery's games. Under the gaming systems vendor contracts, the Lottery is committed to future obligations.

The Lottery is committed to 4.18% of online sales to its central system provider through November 2010 and 7.8987% of instant sales through November 2008. For video lottery, the Lottery is committed to 1% to the central system provider through November 2010 and a percentage ranging from 4.0% to 6.5% to the video lottery terminal providers through June 1, 2011.



## DELAWARE STATE LOTTERY

### Notes to Financial Statements

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The Lottery's commitments to gaming vendors, as described above, comprise the majority of the following commitments. The commitments to gaming vendors included in these commitments are based on management's sales projections for the respective years, as follows:

2008	\$	48,187,600
2009		46,676,400
2010		44,560,500
2011		39,453,000
2012		350,000
Thereafter		—
	\$	<u>179,227,500</u>